CHAPTER 2

Application of derecognition requirements to a factoring arrangement

This article aims to:

- Provide key considerations to determine whether a factoring arrangement results in derecognition of financial assets

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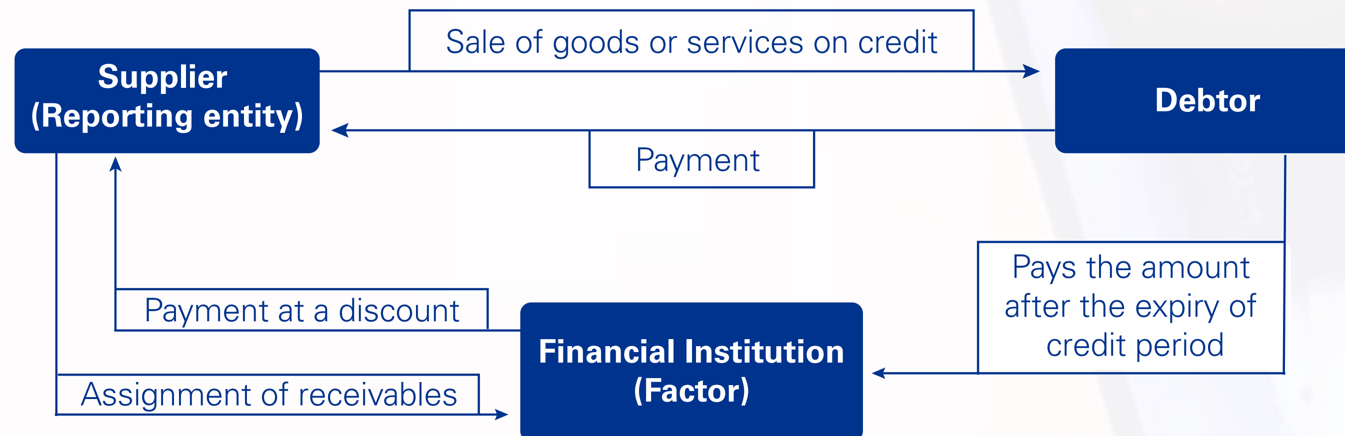
Introduction

Factoring helps the company to improve its cashflows. It is a means of working capital financing which is frequently used by companies across industries. It involves three parties: an entity that sells the receivables (supplier), a debtor who has a financial liability to make a payment to the supplier and a financing institution (a factor) that purchases accounts receivable from supplier at a discounted price.

The factoring arrangement typically allows the entity that is a supplier of goods or services to obtain cash from a bank or a financial institution (i.e. the factor) against receivables due from the entity's customers.

The factoring arrangement might take different legal forms e.g. the receivables might be sold to the factor or pledged as security for a loan from the factor and the factor may or may not have recourse to the entity in the event that the customer does not settle. A traditional factoring arrangement is initiated by the entity and the factor, rather than the customer. In many cases, the customer might be unaware of the arrangement.

The factor may also provide different types of services related to collection of suppliers account receivables from the debtor, credit control and protection, etc., which helps to save time and the cost of collecting customers receivables.



(Source: KPMG IFRG Limited's Insights into IFRS, 19th Edition 2022/23)

The terms of factoring arrangements vary depending on the agreement between the entity, its debtor and the financial institution. Therefore, when a company sells its receivables to a factor, from its financial reporting perspective it would need to analyse whether such account receivables can be derecognised from its balance sheet.

In this regard, a detailed evaluation of the term factoring arrangements is required. As accounts receivable fall within the scope of Ind AS 109, *Financial Instruments*, a company would need to follow its guidance to evaluate if such assets can be derecognised.

Illustrative example

Generally, a company enters into an agreement with a bank to 'sell and assign' its accounts receivables to the bank. The terms of the sale/assignment could include following terms:

- The benefit of all guarantees, indemnities and securities in respect of the account receivables shall be assigned to the bank with full title guarantee upon purchase of accounts receivables by the bank and upon payment of purchase price.
- Upon purchase of accounts receivable, the bank would pay to the company 100 per cent of value of the aggregate accounts receivables net of appropriate discount/interest charged till maturity date.
- The bank may appoint the company as its agent (without any consideration) to collect all amounts due in respect of each account receivable. The bank may, at any time and in its sole discretion replace the company as its agent.
- In case the receivables are not collected, the recourse to the company is as below:
  - If failure to pay is due to certain 'excluded risk events', the face value of such receivables would be paid by the company to the bank and the receivables would be re-assigned to the company
  - If failure to pay is due to 'insolvency events', then the company would bear first loss which shall not exceed 5 per cent of the maximum facility amount during any calendar year.

In order to analyse whether in this fact pattern the company can derecognise its accounts receivables, following principles would be important to consider:

- Whether derecognition principles are applied to a part of all of an asset?
- Have the rights to the cash flows from the asset expired?
- Has the company transferred its rights to receive the cash flows from the asset?

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Determining the financial asset subject to derecognition

In applying the derecognition principles under Ind AS 109, the first step is to determine the financial assets that are subject to possible derecognition. This could be specifically identified, fully proportionate share of the cash flows of the financial assets or fully proportionate share of specifically identified cash flows from a financial asset or a group of similar financial assets.

Ind AS 109 indicates that the derecognition assessment may be applied either to an individual financial asset or to a portfolio of similar financial assets. However, Ind AS 109 does not specify the circumstances in which a portfolio assessment is appropriate. This assessment would depend on the contractual terms for transfer of financial assets.

In this case, the company has provided a first loss recourse up to a maximum of 5 per cent of the facility amount during the calendar year. Hence, the assessment should be done at the portfolio level of accounts receivables sold/assigned.

Transfer of rights to receive cash flows

A financial asset qualifies for derecognition under Ind AS 109 either if the contractual rights to the cash flows from that financial asset expire or if an entity transfers a financial asset in a transfer that meets the criteria for derecognition specified in Ind AS 109.

An entity is considered to have transferred a financial asset only if it transfers the contractual rights to receive the cash flows of the financial asset or it enters into a qualifying pass-through arrangement.

Generally, transfer of legal title would result in a transfer of all existing rights associated with the financial asset, however, a transaction involving sale of beneficial interest in an asset without an actual transfer of legal title should be assessed for 'transfer of rights to receive cash flows' considering the facts of the case. In either case, for a transfer of contractual rights to take place, the transferee should have an unconditional right to demand payment from the original debtor in the case of default by the original debtor.

A right to demand payment or to obtain legal title that is conditional on the transferor defaulting under a servicing agreement does not constitute a transfer of contractual rights.

A transferor may continue to administer or provide servicing for assets that it has previously transferred to another entity. For example, a transferor may transfer all rights to receivables but then continue to collect the cash flows of those receivables as a servicer in the capacity of an agent of the transferee. The IFRS Interpretations Committee discussed a related issue and noted that the determination of whether the contractual rights to cash flows have been transferred is not affected by the transferor retaining the role of agent to collect the cash flows of the receivables in this case. Therefore, retention of the servicing rights by the entity transferring the financial asset does not in itself cause the transfer to fail the derecognition principles.

In this case, the company has transferred its contractual rights to receive its receivables to the bank and it is merely continuing to act as a service/administrator to collect the outstanding dues on behalf of the bank.

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Transfer of substantial risks and rewards

An entity needs to evaluate whether:

- The company has transferred substantially all the risks and rewards, or
- The company has retained substantially all the risks and rewards or
- The company has neither transferred nor retained substantially all the risks and rewards.

The risks and rewards analysis is performed by comparing the entity's exposure, before and after the transfer, to the variability in in the amounts and timing of the net cash flows (present value of the future net cash flows) from the financial asset.

There is no specific guidance provided in Ind AS 109 on what constitutes 'substantially' all of the risks and rewards of a financial asset. Assessing whether and to what extent exposure to variability in the present value of cash flows has been retained requires consideration of all relevant facts and circumstances. This analysis should be based on the terms of the contract and other facts and circumstances, considering all of the risks inherent in a financial asset (excluding dispute risk and other legal risks) associated with the financial asset on a probability-weighted basis. Generally, dispute risk and other legal risks is not considered for the risks and rewards analysis, because it relates to the existence of a financial asset rather than to the risks and rewards inherent in a financial asset.

In this case, there is a clause with regard to excluded risk events i.e. If the failure to pay is due to 'excluded risk events', the face value of such receivables would be paid by the company to the bank and the receivables would be re-assigned to the company. Excluded risk events generally include aspects like – dispute, fraud or breach of agreement by the company, i.e. cover dispute or legal risks.

Thus, on the basis of guidance from Ind AS 109, excluded risk events would be ignored for the purpose of assessing whether substantial risk and rewards have been transferred to the bank.

In case of financial assets with short maturities such as most accounts receivables, the only substantial risk is generally credit risk. Thus, the evaluation of risks and rewards shall depend on which party has assumed the risk of possible credit losses.

In this case, if failure to pay is due to 'insolvency events' then the company would bear first loss which shall not exceed 5 per cent of the maximum facility amount during any calendar year.

The company is transferring receivables with relatively short maturities for which the only substantial risks in credit risk (i.e. risk of default). The interest risk is transferred to the bank but the same is not expected to be significant given the short maturities.

Hence, the risk borne by the company to be considered for derecognition assessment is the first loss upto 5 per cent of the maximum facility amount during any calendar year.

Thus, basis above, **the company should perform an appropriate risk and reward analysis** to determine if the accounts receivables should be derecognised i.e. if the likely Expected Credit Loss (ECL) range of the portfolio of receivables is 0 to 5 per cent then it should be concluded that by way of first loss recourse of upto 5 per cent, the company has retained significant risks and rewards and hence, accounts trade receivables are not derecognised. The company should not only consider the historical experience but also consider the aspects like – credit rating of the customer, etc. in determining the likely ECL range of the portfolio transferred to the bank.

For other situations, it may require appropriate statistical analysis to determine if significant risk and rewards are transferred or retained or neither transferred nor retained.

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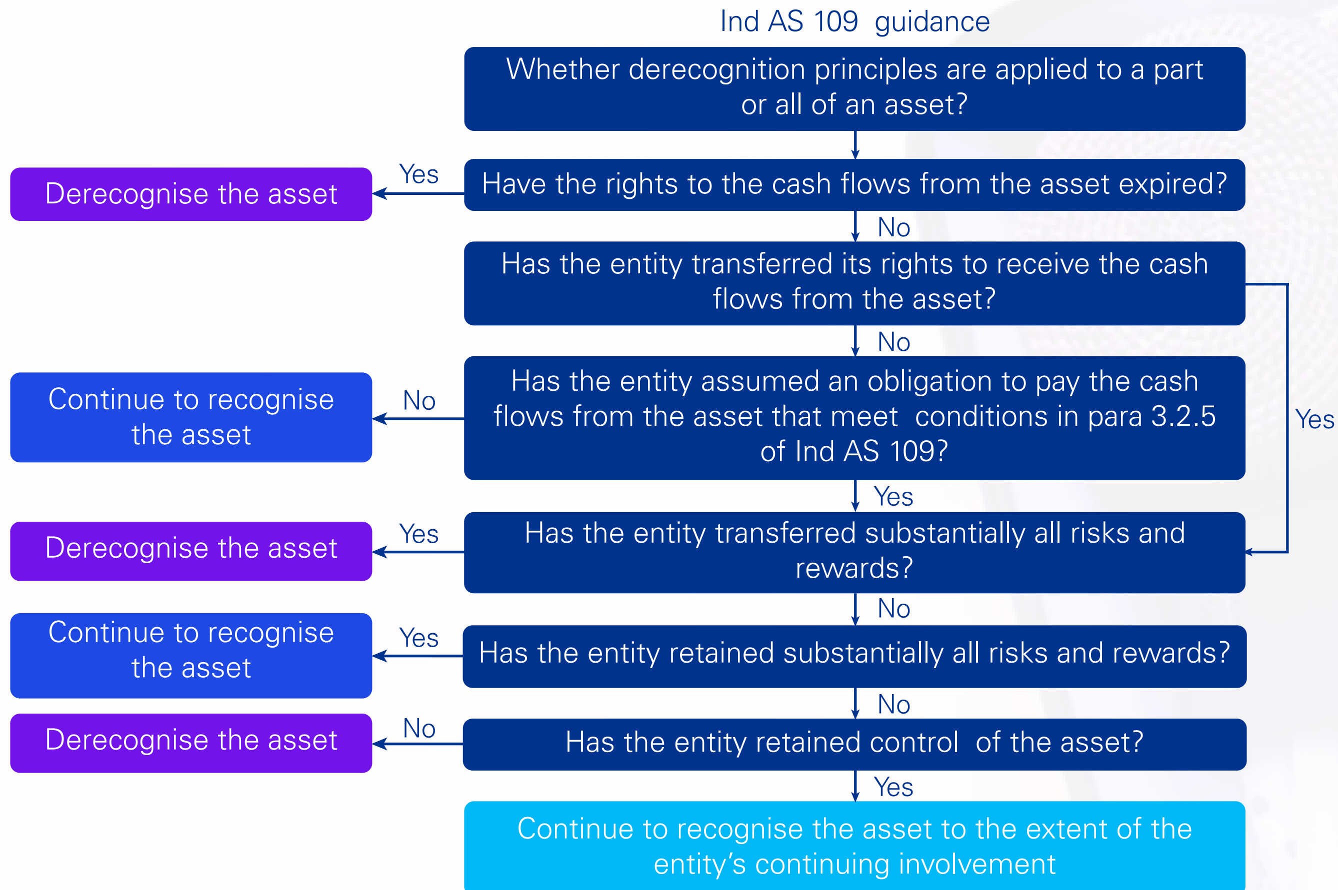
Key considerations for determining financial asset subject to derecognition

Ind AS 109 advocates detailed guidelines on the principles to be applied while derecognising financial assets. These are assessed in Figure 1 below:



Source: KPMG IFRG Limited's Insights into IFRS, 19th Edition 2022/23

Key points for consideration

Each factoring arrangement must be assessed separately, taking into account the contractual terms and conditions.

Entities should also carefully consider the disclosures that will be necessary to explain the nature of the factoring arrangement, impact of the arrangement and the judgements made by the entity.

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